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In the Supreme Court of the United States

OCTOBER TERM, 1929

L. M. WILLCUTS, AS COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MINNESOTA, PETITIONER

v.

CHARLES W. BUNN

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF

INDEX

	Page
Petition:	
Statement	2
Specification of error to be urged	3
Reasons for granting the writ	3
Brief in support of the petition:	
Opinions below	5
Jurisdiction	5
Question presented	5
Statute involved	5
Statement	6
Argument	7
Conclusion	13
Appendix A: Rulings of the Treasury Department	14
Appendix B: Opinion of the Circuit Court of Appeals, Sixth Circuit, in Charles H. Nauts, Collector, v. W. L. Slayton	15

CITATIONS

Cases:	
Greiner v. *Lewellyn*, 258 U. S. 384	12
Heiner v. *Colonial Trust Co.*, 275 U. S. 232	8
Metcalf & Eddy v. *Mitchell*, 269 U. S. 514	10
National Life Ins. Co. v. *United States*, 277 U. S. 508	9
Nauts v. *Slayton* (C. C. A. 6th), decided December 6, 1929	4, 12
Orr v. *Gilman*, 183 U. S. 278	4, 11
Panhandle Oil Co. v. *Knox*, 277 U. S. 218	10
Plummer v. *Coler*, 178 U. S. 115	4, 9, 11
Statute:	
Revenue Act of 1924, c. 234, Sec. 213 (a), 43 Stat. 253, 267 (U. S. C., Title 26, Sec. 954)	5
Miscellaneous:	
Annual Report of the Secretary of the Treasury for 1921, pp. 680–685	9
Grimes & Craigue, Principles of Valuation, 1928, p. 204	9
O. D. 647, Cumulative Bulletin No. 3, July–December, 1920, p. 123	7, 14
O. D. 737, Cumulative Bulletin No. 3, July–December, 1920, p. 49	7, 14
O. D. 762, Cumulative Bulletin No. 4, January–June, 1921, p. 31	7, 15

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PETITION

The Solicitor General on behalf of L. M. Willcuts, Collector of Internal Revenue for the District of Minnesota, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit entered in the above case on September 23, 1929 (R. 17), affirming the judgment of the District Court for the District of Minnesota. (R. 7.)

STATEMENT

At various dates in the years 1919 and 1920 the respondent purchased for cash as investments certain bonds issued by various counties and cities in the State of Minnesota. The record does not disclose whether these bonds were purchased from a political subdivision or from some one else, nor does it appear whether the bonds were purchased at, above, or below par. In the month of January, 1924, the respondent sold these bonds and realized upon the whole transaction a net profit (disregarding interest accrued on coupons) of $736.26. He did not include any part of this profit in his income tax return. The Commissioner added this profit (less a net loss of $41.20 suffered by the respondent on certain similar bonds held less than two years) to the respondent's income, and assessed an additional tax of $85.44. This additional tax, together with interest amounting to $14.07, the respondent paid on demand under protest on May 8, 1928. He then filed a claim for refund which was rejected. (R. 2.)

The respondent filed his complaint in the United States District Court for the District of Minnesota (R. 1) and the petitioner demurred. (R. 3.) The District Court overruled the demurrer (R. 4) and, upon failure of the petitioner to answer, entered judgment for the respondent. (R. 8.) From this judgment an appeal was prosecuted to the Circuit

Court of Appeals for the Eighth Circuit, which sustained the lower court. (R. 17.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that Congress may not constitutionally impose an income tax on gains derived by the owner of municipal bonds from the sale of such bonds at a profit.

REASONS FOR GRANTING THE WRIT

The question whether the Federal Government may constitutionally tax the gain derived from the sale of municipal bonds by an individual is an important one which has not been but should be settled by this Court. The Treasury Department has consistently interpreted the Revenue Acts as imposing an income tax on such gain. In overturning this uniform construction the Circuit Court of Appeals has relied upon decisions of this Court which hold that the Federal Government can not interfere with the exercise by a State of its governmental powers. The facts in the instant case do not involve the exercise by a State of its governmental powers. No attempt is being made to tax the bond itself, nor the interest thereon paid by the State. A tax in such cases would concededly be unconstitutional. Here, the transaction which gives rise to the imposition of the tax is between individuals, and not between an individual and a State or a subdivision thereof.

The possibility of a future conflict of decisions on the question here involved is indicated by the opinion of the Circuit Court of Appeals for the Sixth Circuit in *Nauts* v. *Slayton,* decided December 6, 1929, not yet officially reported (see Appendix B), where, in discussing the instant case, the court said: "Even were we to consider the question [in the *Bunn case*] as not foreclosed by the holdings of the Supreme Court in *Plummer* v. *Coler,* 178 U. S. 115; *Orr* v. *Gilman,* 183 U. S. 278, it is not now before us."

The question involved is far reaching in its application and importance. It equally affects the power of States to impose a similar tax upon profits on sales of United States obligations. The decision of the Circuit Court of Appeals thus affects thousands of taxpayers.

Wherefore, it is respectfully submitted that this petition for certiorari to review the judgment of the Circuit Court of Appeals for the Eighth Circuit should be granted.

CHARLES E. HUGHES, JR.,
Solicitor General.

DECEMBER, 1929.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the District Court (R. 4) is reported in 29 F. (2d) 132. The opinion of the Circuit Court of Appeals (R. 15) is reported in 35 F. (2d) 29.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on September 23, 1929. (R. 17.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is the imposition of a tax on gains derived by the owner of municipal bonds from the sale of such bonds at a profit unconstitutional?

STATUTE INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 267 (U. S. C., Title 26, Sec. 954):

> SEC. 213. For the purposes of this title, except as otherwise provided in section 233—
>
> (a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the Presi-

> dent of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period.

While the Treasury Department has promulgated no formal regulations with respect to the inclusion in taxable income of a profit derived from the sale of State and municipal bonds, it has consistently ruled that such profits are taxable. The published rulings on the subject are set out in Appendix A.

STATEMENT

The statement of the facts and the error relied upon will be found in the petition.

ARGUMENT

A Federal tax on a State or municipal bond would be invalid. So would a tax on the interest. But a tax on profit derived from the sale of the bond is neither a tax on the bond nor on the interest. It is a tax on the gain from a transaction wholly apart from the contract between the municipality and the lender, and to which the bond is only an incident.

The Treasury Department in its rulings has been meticulous in its care to keep strictly within constitutional limitations by imposing the tax only upon the profit from the sale of State and municipal securities. Those rulings recognize that neither the purchase of the bonds at a discount from the State nor the redemption by the State of its securities at par produces taxable profit. Discount on the original issue by the State merely represents interest in an altered form. It is part of the cost to the State of the money borrowed. In fact, though not in name, it is additional interest. Consequently, the Treasury Department has exempted it from taxation. O. D. 647, 3 C. B. 123; O. D. 737, 3 C. B. 49; O. D. 762, 4 C. B. 31. (See Appendix A.)

For the purpose of this brief, it is not thought necessary to deal with the limitations of the rule as applied to the subsequent sale at a profit of bonds originally issued by the State or municipality at a discount. In the discussion which follows, therefore, we do not use the terms "gain" or "profit" as

including, in cases where the bonds sold were originally issued at a discount, such part of the sum received by the seller as is solely attributable to that fact.

Even if it be conceded that an income tax on the profit from a sale of State securities may have some perceptible economic effect upon the borrowing power, that fact is too narrow a basis upon which to rest the conclusion that the taxation of such profit is beyond the power of Congress. *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235. The Circuit Court of Appeals, in the instant case, however, rests its decision upon that basis. It said (R. 16):

> Anything which would usually influence the public in buying or refraining from buying such securities unquestionably is a burden upon such loans and an impediment to such borrowing power. It is a matter of common knowledge that municipal securities are almost always issued for a long term of years. If the original buyers of such from the municipalities were confined to those who expect to hold such until maturity, comparatively few such securities would issue and upon terms not favorable to the municipalities. It is also common knowledge that the interest rate on such securities is usually lower than upon currently issued private securities. Two of the main attractions of such securities are that they are tax free and offer a chance for profit in resale.

The court thus condemns the tax on the ground that the statute, if applied as written, may pos-

sibly have some perceptible economic effect upon the market for bonds. This seems to be a departure from the rule laid down by this Court in *Plummer* v. *Coler,* 178 U. S. 115, where it is said (p. 137):

> But when the effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

The injury here is certainly not obvious. The borrowing capacity of States, counties and cities has not been curtailed. The estimated amount of securities issued by such bodies had grown by January 1, 1922, to the total of $8,142,000,000, then outstanding. (See *National Life Ins. Co.* v. *United States,* 277 U. S. 508, 532.) This amount equalled approximately one-third of the Federal indebtedness outstanding on June 30, 1921, though that indebtedness embraced the entire war obligations of the Government. (See Annual Report of Secretary of the Treasury for 1921, pages 680 to 685.) But, in spite of this vast amount, the cost to States, counties and cities of borrowed money has remained practically constant in a rising money market. (Grimes & Craigue, Principles of Valuation, 1928, page 204.)

Nor is the injury here appreciable. As this Court said in *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514, 523:

> In a broad sense, the taxing power of either government, even when exercised in a manner admittedly necessary and proper, unavoidably has some effect upon the other. The burden of federal taxation necessarily sets an economic limit to the practical operation of the taxing power of the states, and *vice versa.* Taxation by either the state or the federal government affects in some measure the cost of operation of the other.

When a city sells its bonds, it of course agrees to pay at maturity the principal amount of the bonds and in the meantime a stated interest at stated periods. This is its obligation, and it is admitted that no tax can be imposed which increases that obligation. *Panhandle Oil Co.* v. *Knox,* 277 U. S. 218. Beyond this the obligation of the city does not go. It does not guarantee, or even hold out, a prospective gain or increment in the value of these bonds. It may be that the fact that any gain on a sale of bonds purchased would not be taxable would be attractive to a prospective investor. The possibility theoretically may affect the price, but common experience demonstrates that its influence must be relatively remote. The advantage resulting from the exemption affects directly and immediately only the purchaser. It exists only in prospect. Necessarily its bearing upon the

city's credit is shadowy and of but slight importance.

In the case of *Plummer* v. *Coler, supra,* identical contentions were made as are made here. It was there contended that the tax on inheritance would, by deterring individuals from investing in Federal securities, lessen the demand for such securities; that individuals would be driven to consider, when making their investments, whether they could rely on their heirs and legatees receiving United States bonds unimpaired by State action in the form of taxation; and that, if it should be held that such taxation was lawful, capital would not be invested in United States bonds on terms as favorable as if the Court were to hold the tax invalid. But the court said that the tax was valid, intimating that the supposed burden was "merely fanciful" or certainly no greater than the burden placed upon such securities by State laws taxing franchises of corporations, and held that (p. 136):

> * * * the mischief to our national credit, so feelingly deplored in the briefs, caused by state taxation upon estates of decedents, would be inappreciable, and too remote and uncertain to justify us now in condemning the tax system of the State of New York.

See also *Orr* v. *Gilman,* 183 U. S. 278. Conversely Congress may require that municipal bonds be included in determining the value which is the

measure of the Federal Estate Tax. *Greiner* v. *Lewellyn*, 258 U. S. 384.

There is even a greater degree of remoteness in the instant case than in those above cited. The imposition of an inheritance tax is certain where the decedent owns property, bonds included, sufficient in amount. The imposition of a tax in the situation here presented, however, is contingent upon the possibility that the owner may sell, and the further possibility that he may sell at a profit. Accordingly, it is submitted that the burden here, if any, upon the borrowing power of the State, is too remote to make the tax unconstitutional.

The recent decision of the Circuit Court of Appeals for the Sixth Circuit, in the case of *Nauts* v. *Slayton*, decided December 6, 1929, not yet reported (See Appendix B), foreshadows a possible conflict on the question here involved. In that case, which raised the question of the constitutionality of the disallowance by the Commissioner of Internal Revenue of interest paid by a taxpayer on money which he borrowed to purchase municipal bonds, the court said:

> In arriving at the conclusion indicated we have not been at all influenced by the holding in *Bunn* v. *Willcuts, Collector*, 29 Fed. (2nd) 132, a decision of the District Court of the District of Minnesota, to which the taxpayer has specifically called our attention. In that case there was a holding that not only was the interest from Municipal securities

exempt from Federal taxation, but also that profit made from the purchase and sale of such securities is likewise exempt. Even were we to consider the question as not foreclosed by the holdings of the Supreme Court in *Plummer* v. *Coler,* 178 U. S. 115; *Orr* v. *Gilman,* 183 U. S. 278, it is not now before us. Here no question is raised as to the taxability of profits made in the purchase and sale of Municipal bonds. Such profit was included in gross income, and the tax paid upon it is not herein sought to be recovered.

CONCLUSION

Wherefore, it is respectfully submitted that the petition for a writ of certiorari in this case should be granted.

CHARLES E. HUGHES, JR.,
Solicitor General.

G. A. YOUNGQUIST,
Assistant Attorney General.

SEWALL KEY,
JOHN G. REMEY,
Special Assistants to the Attorney General.

DECEMBER, 1929.

O. D. 647, Cumulative Bulletin No. 3, July–December, 1920, page 123:

> Profit derived from noninterest-bearing State and municipal securities purchased at a discount and held until maturity is not taxable where it clearly appears that the return from the investment in the hands of the taxpayer is due solely to the compensation received from the State or municipality in lieu of interest for the use of the taxpayer's money. In no case may such exemption exceed the total discount at which the securities were originally sold by the State or municipality.

O. D. 737, Cumulative Bulletin No. 3, July–December, 1920, page 49:

> Profit derived from State and municipal securities purchased at a discount is not taxable in the hands of the person holding such obligations at maturity except that in no case may such exemption exceed the total discount at which the securities were originally sold by the State or municipality.
>
> Inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount), any person selling municipal bonds for an amount in excess of the cost of the bonds to him (or their fair market value as of March 1, 1913, if they were acquired prior to that date) realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount.

O. D. 762, Cumulative Bulletin No. 4, January–June, 1921, page 31:

> The M bank purchased certain 10-year 4½ per cent municipal bonds at 96.10 which had been originally issued and sold by the municipality at 94.50. The question is presented as to whether in case the bank sells the bonds before maturity at 98, the profit realized will be exempt in its hands.
>
> Held, that inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount) any person selling municipal bonds for an amount in excess of the cost of the bonds to him realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount.
>
> If, therefore, the bank sells at $98 the municipal bonds issued at $94.50 and purchased by it at $96.10 it will derive a taxable profit of $1.90 on each bond sold. If, however, it holds the bonds to maturity and receives $100, the difference between the purchase price of the bonds and the amount received or $3.90 will represent exempt income to it.

Appendix B

No. 5437. United States Circuit Court of Appeals, Sixth Circuit. Charles H. Nauts, collector of internal revenue, appellant, *v.* W. L. Slayton, appellee. Appeal from the United States District Court, Northern District of Ohio, Western Division. Decided December 6, 1929

Before Moorman and Hicks, Circuit Judges, and Simons, District Judge.

SIMONS, District Judge: This action is to determine the applicability of provisions of the Revenue Act of 1921, to admitted facts, and their constitutionality as applied. For convenience plaintiff in the court below, and appellee here, will be referred to as the taxpayer; the defendant below as the collector.

During the year 1922 the taxpayer was engaged in the business of buying, selling and dealing in Municipal bonds. During that year he received as interest from bonds owned by him $65,720.06. During the same period he paid as interest on money borrowed to buy and carry such bonds the sum of $78,153.84. In his return for the year he excluded from his gross income the interest from the bonds, for the reason that such income was exempt. He deducted interest paid during the year and set it off against profit made upon the sale of bonds. Upon audit of his return, the Treasury Department disallowed the deduction of interest paid and assessed additional taxes based upon a recomputation of his income after the disallowance of such deduction. These additional taxes were paid. Claim for refund was duly filed and rejected, and the taxpayer sued for the purpose of recovering the paid additional tax. To the taxpayer's petition the defendant demurred. The Court overruled the demurrer, and upon failure of the collector to plead entered judgment in favor of the taxpayer and as against the collector for the amount claimed. This appeal is taken by the collector to review the judgment.

The Treasury Department in disallowing the taxpayer's deduction of interest paid, and in assessing an additional tax, assumed to act under the authority of Sections 213 and 214, of the Revenue Act of 1921. Section 213, defining gross income, specifically exempts interest upon obligations of a State, Territory, or any political subdivision thereof. Section 214–a provides that in computing net income there shall be allowed as deductions,

> 2. All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities, * * * the interest upon which is wholly exempt from taxation under this little.

The taxpayer bases his right to recovery upon two main contentions. First, that he is not an investor in tax exempt securities, but a dealer; that the section is intended to reach only those who invest in tax exempt securities for the purpose of producing non-taxable income, and that as his primary purpose is to produce taxable income, to wit, the profits made upon the purchase and sale of tax exempt securities, and that as such primary purpose is set up in his petition and admitted by the demurrer, Section 214 a–2 is not applicable to him. Furthermore, that in his case the interest paid ought not to be treated purely as interest, but as one of the legitimate and necessary expenses of doing business, to be deducted from gross income in order to ascertain his net income. Secondly, that if the statute is applicable to him, it is unconstitutional, as imposing a burden upon the obligations and securities of a State or its political subdivision.

The District Judge held that the statute did not apply to admitted facts; that so to apply it would make the enactment unconstitutional, and that it is susceptible to a reasonable construction to avoid unconstitutionality. Were there any ambiguity in the language of the section, such rule of statutory construction might be here considered, but we find none. The terms of the section are plain, and being clear the letter of the law must control. We pass over also without detailed consideration the contention that the interest paid must be treated not as pure interest, but as one of the elements in the cost of doing business. Even were we to consider that there are here present the special circumstances under which interest may be treated as among the "ordinary and necessary expenses" suggested by the Supreme Court in *Anderson* v. *42 Broadway Company*, 239 U. S. 69, it is clear from the circumstances of this particular case that the only interest paid that could be so treated would be the excess of interest paid over the amount of interest received. Manifestly this is not the interest here in question, nor upon the disallowance of which this suit is based. The taxpayer herein is seeking to recover all of the additional tax computed upon the disallowance of a deduction of all of the interest paid.

We come then to the disputed constitutionality of the statute. The taxpayer relies upon and the collector challenges the holding of the Supreme Court in *National Life Insurance Company* v. *United States*, 277 U. S. 508, as authority for the invalidity of the section herein considered. In that case the Court was called upon to deal with Section

245-a of the Revenue Act of 1921. That section provided:

> a—That in case of a life insurance company the term net income means the gross income less—
>
> 1. The amount of interest received during the taxable year which under paragraph (4) of subdivision (c) of Section 213 is exempt from taxation under this title (interest on tax exempt securities);
>
> 2. An amount equal to the excess, if any, over the deductions specified in paragraph (1) of this subdivision of four per centum of the mean of the reserve fund required by law and held at the beginning and end of the taxable year.

The petitioner therein maintained that the result of the collector's action in deducting from the four per cent of the mean of the reserve fund an amount equal to the petitioner's income from tax exempt securities was unlawfully to discriminate against it and really to exact payment on account of its exempt securities, contrary to the Constitution and laws of the United States, and also that diminution of the ordinary deduction of four per cent of the reserve because of interest received from tax exempt securities in effect defeated the exemption guaranteed to their owners. The Court held that one may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted. Also, that the Congress has no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others.

The collector here seeks to distinguish the situation with respect to tax exempt securities provided for in Section 245 from that in Section 214. He contends that the statute involved in the Insurance Company case gives to all taxpayers exactly the same deduction; that no one is entitled to deduct the interest which he pays to purchase or carry Municipal bonds, and on the other hand, that everyone is entitled to deduct all other interest. In our judgment the situation created by the two sections with respect to the taxation of tax exempt securities is the same, and the applicable principle identical. To deprive the taxpayer of the right to deduct from gross income interest that he has paid during the taxable year because that interest was paid on money borrowed to purchase tax exempt securities is, looking through form to substance, directly to tax the interest of such securities, and so not within the power of Congress to authorize. It is important to note that the Supreme Court in the *National Life Insurance case* considered the deduction of tax exempt interest from the four per cent allowance a direct and purposeful tax upon a State obligation, and did not rely upon any rule to the effect that what Congress may not do directly it cannot do indirectly. This renders unnecessary a consideration of those cases wherein the exercise of the Congressional authority to tax more or less remotely affected the sale of State securities, or remotely or incidentally impaired the borrowing power of the State. Typical of such cases is *Plummer* v. *Coler,* 178 U. S. 115; *Florida* v. *Mellon,* 273 U. S. 12. As we shall see presently, the tax in the instant case is even more obviously a direct tax

upon the income of State obligations than was the tax in the Insurance case.

In the latter it was argued in able dissenting opinions that the four per cent deduction allowed to insurance companies was not given to them as a matter of right; that the allowance of a deduction of four per cent of the mean of the reserve was, as Mr. Justice Brandeis put it, a favor, and as Mr. Justice Stone expressed it, a matter of grace, or a bounty, and in their dissenting opinions (Mr. Justice Holmes concurring with Justice Brandeis), they saw no Constitutional reason why in granting a favor or a bounty the Congress could not lawfully take into consideration an exemption already possessed by the holders of tax exempt securities, every Insurance Company holding such tax exempts being already permitted by the statute to deduct the interest therefrom to the full extent received. In the instant case there is involved no such act of grace on the part of the Congress. There is taken from the taxpayer something which every other taxpayer is allowed, namely the privilege of deducting interest on borrowed money from gross income. It is not a case of making him a gift, and then adjusting the size of the gift to that which he already possesses. To refuse to allow the taxpayer to deduct his interest in effect results in the taxation of something which is not income. We do not here question the power of Congress to make gross income the criterion of a taxpayer's liability, but this it has not done. The settled policy of the Government, in this and other Income Tax Statutes, has been to make net income measure the taxpayer's liability.

In arriving at the conclusion indicated we have not been at all influenced by the holding in *Bunn* v. *Willcuts, Collector,* 29 Fed. (2nd) 132, a decision of the District Court of the District of Minnesota, to which the taxpayer has specifically called our attention. In that case there was a holding that not only was the interest from Municipal securities exempt from Federal taxation, but also that profit made from the purchase and sale of such securities is likewise exempt. Even were we to consider the question as not foreclosed by the holdings of the Supreme Court in *Plummer* v. *Coler,* 178 U. S. 115; *Orr* v. *Gilman,* 183 U. S. 278, it is not now before us. Here no question is raised as to the taxability of profits made in the purchase and sale of Municipal bonds. Such profit was included in gross income, and the tax paid upon it is not herein sought to be recovered. Indeed the petitioner's argument in support of the contention that the statute does not apply to him is founded upon the claim that the primary purpose of his borrowing was to produce taxable income, and not tax exempt income.

In view of Section 1403, of the Act, it is necessary to go no further than did the Court in the National Life Insurance case, and so to hold that the disallowance of interest paid and the additional tax assessed against the taxpayer based upon such disallowance cannot be given effect as against the taxpayer under the circumstances here disclosed. He was lawfully entitled to the judgment obtained in the court below, and

It is hereby affirmed.

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